wire centers or to a specific, small geographic region. And that, we think, is more consistent with requirement of the Act.

COMMISSIONER ABERNATHY: Why don't we go ahead and move on to Billy Jack.

CONSUMER ADVOCATE GREGG: It's hard to know where to start. There are so many issues and so many questions. But I guess we may as well start with this, I'm sure you all saw this on the cover of the USA Today yesterday, the story about universal service paid out to rural companies.

The allegations in the story and the anecdotes that were given is that there are a number of small rural companies that were earning well into the 20 percent range, paying out large dividends and large salaries to their employees, that nevertheless pulled down large amounts of federal universal service funds.

There are currently state universal service funds that take a last look after the mechanism has run before they determine whether any additional funds or support should be paid out. They look at a bottom line, whether that's earnings or a certain specified amount of revenues over the earnings. The federal universal service fund for rurals does not look at costs. And, in fact, local switching does not even -- I'm sorry, looks at cost. Local switching does not even look at cost in paying out support.

Has the time come for the federal universe service support mechanisms to take a last look, either based on total revenues produced by the loop -- and we considered unseparated loop costs -- or to look at the bottom line return in determining whether additional federal universal service funds should be paid out? And I'll just put that open to any of the panelists.

MR. WELLER: I guess we need a volunteer. I'll step forward.

I think this is sort of a fundamental question we have to ask ourselves about philosophy here before we get into specific details, because there are all sorts of ways that we can go back to more regularly approaches. I've already mentioned, you know, constructing cost models and tried to prescribe costs. We can also sort of -- we can go back and audit people trying to look for bad actors, or we can suck back into regulation, processes that are starting to step away from it.

I think the answer to your earlier question about what do we do in a broadband age is that we don't get more with regulatory, we get less from regulatory. As I said earlier, I think we need to find ways to have universal service be efficient, but we need to be clever in thinking of ways to do that that don't rely on more regulation because we probably want to decouple universal service from regulation. And the amount of support that's needed in area may be separate from the amount of regulation that's needed in an area. So, I would be very concerned about a mechanism that would require us to go back and do essentially a rate case on every company at the end of every year, even though I think that's well intentioned.

I think something that sets incentives in the structure of the payouts in the manner that we've had good results from, is incentive regulation both at the federal level and the state level in the last 15 years is a simpler, less contentious, and ultimately more productive way of going about things.

CONSUMER ADVOCATE GREGG: Dr. Selwyn?

DR. SELWYN: Thank you. You know, the proponents of embedded cost as the basis for support seem to want to have it both ways. They want to retain the trappings of a regulatory burden while not actually -- in terms of the basis for funding without actually accepting the mechanism of regulation to determine that the funding is reasonable.

What we have right now is -- and I think there's very strong evidence of this -- is that carriers in rural areas who are getting high-cost support are also able to exploit -- and I don't mean that in a pejorative sense. They're able to exploit their infrastructure to develop new revenue sources from broadband services, DSL, other things that are capable of producing revenues sufficient to defray all their costs. And in those circumstances it seems to me that it's entirely unreasonable for anyone outside of those communities to also be asked to provide subsidy.

As I mentioned, there is strong evidence that these properties are valued at well in excess of embedded costs, which means that people buying them -- smaller companies, smaller midsize companies that are buying rural exchanges are prepared to -- are willing to in effect capitalize future excess earnings by paying premium prices over the cost of support for those assets.

That in itself is evidence of the sufficiency of the existing revenues from all sources, because that's what the buyer looks to. The buyer does not limit the scope of a decision to regulated revenue. The buyer looks at all revenues. At an aggregate level, the holding companies that own a lot of exchanges that are receiving high-cost support are similarly being traded. Their equities are being traded well in excess of book values. So, their investors, their public stockholders, are making a similar kind of choices.

We don't -- in a sense -- maybe I

would be forced to agree that maybe we don't need to do general rate cases on each of these companies because the evidence is overwhelming that their revenues are sufficient without support. But if a company wants support, it seems to me it has to be asked and made to make a showing that that support is required.

MR. GARNETT: In response to your question, we don't think that, you know, the commissioners should get in the business of punishing companies for making money. But at the same time I think that we don't think it's appropriate for universal service to be one of an ETC's best profit centers.

And under the current system, under embedded cost system, and also under the forward-looking system, carriers are guaranteed a rate of return under the high-cost universal service mechanisms. And that rate of turn, by the way, was determined -- was based on the then -- the cost of capital for Bell operating companies 16 years ago, 11.25 percent.

I think that USAC does a pretty good job of paying out high-cost subsidies to the carriers that receive them. I'm guessing that they always get their check from USAC eventually. There's no risk associated with universal service. So, let's get risk-related profits out of the universal service mechanisms.

One thing that CTIA has proposed among a number of fixes to the current system is to basically reduce that 11.25 percent to a lower number that would reflects -- that basically gets that risk-related profit out of the universal service mechanisms. Ultimately, we think that profits should come from consumers, not from the universal service mechanism.

COMMISSIONER NELSON: Mr. Reynolds.

MR. REYNOLDS: Jeff Reynolds with ITTA.

Some of this rate-of-return-bashing, I'll call it, is it's a little bit misplaced. First of all, I'd like to correct the notion that there's a guaranteed return that comes out of rate-of-return regulation. Particularly in the federal rules, it's the opportunity to earn 11 and a quarter. And that just doesn't come cruising in there easily.

Also, relative to the cost recovery mechanism of high-cost universal service, while I agree with Dr. Selwyn that in evaluating acquisition companies certainly look at all revenue streams that are available. There's considerable time between when deals are struck and when those deals are consummated. Particularly for ILECs, there's a considerable process where that's vetted through both the state and the federal regulatory agencies.

So, while there's obviously -- you know, what this historic revenue streams have been as a practical matter when these companies acquire rural exchanges, oftentimes there's considerable investment, considerable risk that goes along with that. You don't get paid back instantaneously. You know, the current embedded cost, rural high-cost universal service mechanism works on a lag basis. So, you're getting a return on your unseparated loop costs, but it doesn't all come back.

And, in fact, as you lose lines to competition over time, you're undergoing considerable risk. In a way an embedded cost mechanism -- and without even the necessity for a rate case, it's self-correcting in the sense that -- to the extent that the reporting mechanisms are in place there, there's a lot of accountability, and it can be measured and monitored. And as Dennis suggested -- although you don't necessarily want to get that business -- if there are abuses and bad actors out there, there's a way to get at them right now. So, I don't -- I find a lot of the rhetoric on this unfounded.

DR. LEHMAN: This is Dale Lehman.

Returning to your pointing to the newspaper, it seems to me there's three courses of action to deal with with issues of abuse.

One of them is, as you suggest, not looking at the earnings of the company. But I share Mr. Weller's concerns that we're headed down a road of much more regulation and really full blown rate cases for every single rural company.

A second course of action is better auditing. Auditing is not perfect, but certainly can be done and more resources put into auditing can catch the, quote, bad actors.

The third course is the one that Mr. Weller suggested, and I think has a lot of appeal, which is just to have better incentives on the cost side and a price cap mechanism which essentially you have on the overall fund today, having frozen the size of it. You know, it has a lot of appeal.

The only thing I caution you is to be careful what you ask for because when you put strong cost-reducing incentives in place, that means strong cost-reducing incentives. And some of those might be in terms of not rolling out broadband as quickly because despite the ability to leverage the existing infrastructure and make broadband revenues, many companies have such low take rates on broadband currently that it is not a profitable investment. And they will think harder about making those investments in the future.

So, before you go down the road of throwing out auditing and saying what you want is stronger incentives, at least make sure that you thought through that you really want cost reduction to be first on the mind of all the companies under universal service funding.

DR. SELWYN: Lee Selwyn.

I don't think this is an issue of bad actors and good actors. Clearly, you can always find some bad actors, and that's what the USA Today article has identified.

But we have a system that does not encourage efficiency, that rewards inefficiency. And even without impugning the integrity or honesty of anybody, the fact is that when a company is confronted with an opportunity to have its costs recovered, to be made whole, irrespective of the way it runs its business, that is an absolute, guaranteed ticket to inefficient operations. And we try to address that to the larger ILECs with price cap regulation. And unless we are prepared to do similar types of monitoring as we did in the pre-price cap days under rate-of-return regulation for these smaller companies, these inefficiencies will persist. And it's not an issue of bad actors. It will persist simply because the institution encourages it.

CONSUMER ADVOCATE GREGG: My second question deals with the role of the states. Under the current universal service mechanisms of the federal government, if a rural company qualifies for support, it receives that support, irrespective of what the state does with rates or with its state universal service fund or whether it has a state universal service fund. The Tenth Circuit Court of Appeals directed the FCC and the Joint Board to develop a support system for non-rurals that contains some sort of inducements to the states to help support universal service. Indeed, the Tenth Circuit said that it had to be a joint effort of states and the federal government.

Do you believe that it would be appropriate to require states to do certain actions first in terms of rates, in terms of state-supported state universal fund and to maximize those state resources prior to calling on consumers in other states to help support their rates within their state?

And I'll ask Mr. Quoit first and then Mr. Garnett.

MR. COIT: Thank you. We definitely believe that something needs to be done along the lines of encouraging states to take a share of the universal service burden. Over the last several years we have seen in non-rural areas, I think, two or three additional ETCs designated. In the rural areas of South Dakota -- and not necessarily all of the rural areas of South Dakota, but we have at this time the incumbent has an ETC; one wireless carrier has an ETC; another wireless carrier that -- actually, two other wireless carriers have applied, and it certainly appears that the second wireless carrier that applied has a fair shot at getting ETC status.

And I look at that and it seems to me that the reason it is happening is that our state Commission has absolutely no skin in the game. They're looking at it as a way of improving wireless coverage, period. And it's made really without regard to, I think, the real facts of some of these -- the reality of the low densities in some of these areas.

Golden West Telcom cooperative is the largest cooperative in the state of South Dakota. It covers about 25,000 square miles. If you look at that and you consider that area to be a state, it would be the 41st largest state in the country. And it serves only 2.1 access lines per route mile of facility throughout that entire area on average. Does it make sense to be designating two, three, four ETCs within that area? We can talk about inefficiencies and waste so forth, but that whole issue of portability and the number of ETCs that are designated, the states have to be accountable. And I don't think today they are.

You mentioned the benchmark. It seems to me that that is a critical element going forward to making sure that, you know, there isn't some abuse. You know, should companies be getting a bunch of USF if their local service rates are 6, 7, 8, $9 a month, no. I don't believe they should, and I think there's a reason for those benchmarks. And that is to not necessarily to require companies to move their rate up to a particular level, but make sure that if they don't that the modest support they get is going to be impacted by that.

MR. GARNETT: We definitely think that states have an important role to play, and the Tenth Circuit has said they do. And in the non-rural proceeding that's certainly something you looked at. And in our comments one thing that we noted is that in many cases you have a situation where rates in rural areas are actually lower than they are often in urban areas. Sprint went into considerable detail on this issue in its comments. SBC talked about this issue a couple of proceedings ago, in the non-rural proceeding.

One idea that we talked about which ultimately didn't make it into our comments but I think is actually kind of an interesting idea is to develop an affordable nationwide rate and support a percentage of costs that are above that benchmark, use that as your benchmark. And that way you can encourage states to do more to increase rates for rural

ILECs and for ILECs generally and to get us to a situation where rural ILECS are getting more than 17, 18, 19, 20 percent of their revenues from customers and away from a situation right now where you have carriers getting 80 percent, in some cases 90 percent of their revenues from a combination of universal service and access.

COMMISSIONER NELSON: Let me pick up on something Dr. Selwyn has mentioned. And that is that no one is looking at the cost and that there is certainly no incentive to control cost under the system.

And I'd like to ask either Dr. Lehman or Mr. Reynolds. I think Mr. Weller has a proposal which responds to that point. And that is to look at the indexing of actual expenditures, looking back at the actual loop cost over a 12-month period and indexing them. Would this be a suitable way to look at controlling costs for rural telcos and should this be applied to all ETCs in the area?

Either Dr. Lehman or Mr. Reynolds.

DR. LEHMAN: This is Dale Lehman. As I was trying to indicate, I think one of the real appeals of this proposal is that it does give cost-reducing incentives. But whether or not that's what you want, I mean, we all think about the good kinds of cost-reducing incentives, which are to avoid waste and inefficiency. Some of the cost reduction might take the form of not rolling out new services well in advance of demand, which many rural carriers have done. So, I'm not entirely sure that maximizing cost reducing incentives is always a wise thing to do.

But on the face of it, I think that does address a lot of the concerns. And for all practical purposes, we are doing that today except not on a carrier level. In terms of the whole fund, it is indexed to inflation, and the fund is not allowed to grow -- you know, we re-initialize the cap, but it's still capped.

CONSUMER ADVOCATE GREGG: Should this be applied to all ETCs in the area, though?

DR. LEHMAN: I'll deal with that in the second panel, because I don't believe this is the basis for the competitive ETCs that are sitting here today.

CONSUMER ADVOCATE GREGG: Mr. Reynolds?

MR. REYNOLDS: I think one of the things with -- I guess I regard the indexing mechanism as unnecessary just from the standpoint that the embedded cost mechanism that's out there right now is self-correcting.

I want to circle back to something that Mr. Weller said relative to the efficiencies that come with holding companies. Most of the operating costs associated with high-cost loops exist at the operating company entity. So, when you've got multiple entities within a state, the efficiencies are not happening in these non-contiguous areas. I think the efficiencies that happen in corporate operation expense exists back at the holding company level. That flows down through the mechanism, so in that sense it's almost self-correcting.

It would probably be interesting to look and see over time how the rural companies on an embedded cost methodology have performed. I know that just from dealing with companies such as CenturyTel and AllTel that they're not even hitting the corporate operating expense limits right now. So, that cap is, to a certain extent, meaningless and those efficiencies are flowing through. So, I think that going to an indexing approach is unnecessary at this point in time.

CONSUMER ADVOCATE GREGG: Joel?

MR. LUBIN: I wanted to clarify a couple points and also ask Dennis a question in terms of his indexing approach, because AT&T also put forward an indexing. And I don't know if it's the same, so I'm going to describe what we talked about and so how parties react.

But for me the dilemma here is that the incumbent rural telcos are rate-of-return regulated. And when you are rate-of-return regulated and then you have, let's say, 1300 study areas, trying to figure out either a price-cap mechanism or a forward-looking costing tool for the diversity and richness of the 1300 rural study areas, is a very complicated process, whether it's a model or whether it's a price cap. And so, right now the way in which they're regulated is rate of return.

Now, it's true that we have a cap on the high-cost fund, but that cap is only on rural telephone company incumbents and it's indexed in aggregate. The CLECs who come in, be it wireless or wired, if they're a CETC, however much money they get is above and beyond the cap, the fund.

So, my question to Dennis is what AT&T put forward was the concept of once a the CETC shows up, be it wired or wireless you, in effect, look at what the incumbent per line is getting. The incumbent going forward, if they lose a lot of lines such that their subsidy per line could skyrocket because they're rate-of-return regulated, their costs really aren't shed, but if, in my extreme, let's say they lose half their lines just to make a point. The subsidy per line could be more than doubled. And we said, that doesn't seem to be fair if the incumbent, because a CETC wins half the lines and doubles the subsidy per line, that the new entrant should get the same amount.

However, it did make sense that if a

CETC entered, be it wireless or wired, they should get the same amount on day one, but not the inflated amount if you're rate-of-return regulated and if the incumbent's losing a lot of lines. However, there was a balancing act. The balancing act is if the incumbent is going to be investing aggressively for whatever reason, moving from circuit switch to IP. Whatever the reason, if they're investing aggressively and the overall revenue requirement was growing, index the day one subsidy per line based on the overall revenue requirement growth of the incumbent.

And all that is attempting to do is create a rough-justice balancing act so that if incumbent is losing a lot of lines and they're rate-of-return regulated, the subsidy per line skyrockets, the new entrant shouldn't get the higher amount going forward. But if the incumbent is investing a lot to upgrade their infrastructure, then presumably someone else who's going to try to compete is going to also have to upgrade their infrastructure. And so that was the indexing that we put forward.

So, my question for Dennis is, is that the kind of indexing you were talking about, because when I'm listening to some of the respondents on the panel, I hear some people saying that they really can't support that concept? But my question is, if you bifurcated it the way I have just done, do people have a different view in terms of seeing it as a rough-justice solution?

MR. WELLER: Rather than go back through all of that, it might be easier for me to explain what exactly I'm proposing.

First of all, I don't think we should -- first of all if we adopt my earlier proposal of one ETC per area, then the issue of bifurcation becomes moot. Where we haven't done that, I don't think we should be bifurcating. I think we should always be the same. I don't think we should be setting up a handicapping mechanism. We shouldn't be saying to one, you're less efficient and we're going to make you a handicap. I don't think that's a good idea.

COMMISSIONER JABER: Excuse me. I'm sorry. I just wanted to let you know that the court reporter has signaled that you all need to use the microphone a little bit closer.

Sorry, Madam Chairman.

MR. WELLER: What we're proposing -- and I think this is also in answer to your question you asked earlier, Commissioner Nelson, is that unlike the current overall cap on the fund, this would apply to all ETCs in all areas, so sort of close that opening in the control mechanism.

Second, it would be specific to each area, not averaged over the entire fund. I think a funny thing about the incentive structure with the current fund is if carrier A spends money in year one that affects carrier B's draw in year two, and might create a little better alignment of interest in carrier A's decision, affecting carrier A. So, we're proposing specific indexing in each area.

And I already mentioned that there might be extraordinary circumstances that would require various escape patches or safety-valve mechanisms. And I think that is actually is a better way of dealing with the kind of service issues that Joel was talking about, because ultimately all I can do is compare to my own company's experience. We've lot of lines over the last few years, and nobody's given us a guarantee.

If you look at a lot of market estimates, many on Wall Street predict that we will have half as many lines in a few years as we had a few years ago. And our response is to invest more in our network to create more value and generate more revenue. And we're doing that without any guarantee or without any sort of bailout. I think ultimately down the line if you're giving rural carriers infrastructure grants, you want encourage them to do the same thing to get as much value out of their network as possible, not as little.

And you'd have to ask how much regulation or interference with their prices you want to step in and do, because it might interfere with that process. And, again, I don't think you want to get in it sort of at this stage on the way there, creating separate mechanisms for different carriers in different markets. I think you need a specific mechanism that pulls each carrier on a per-cost standard. It's set on their starting point. It's not based on which particular cost model we're trying to take things away from them, but saying that going forward they're going to have to manage their business on this basis.

COMMISSIONER NELSON: Real quickly, Joel, and then we'll move on to another question.

MR. LUBIN: Just to clarify, the thought process that I shared with you is really for a rate-of-return entity. What I just described is unnecessary for, let's say, an incumbent like Verizon. The reason why it's not necessary is because we're using a high-cost model. And the high-cost model is a forward-looking model, which does not create the problem.

The fundamental problem that we have is we're not using a high-cost model to independently calculate it. We're using the incumbent's embedded cost. And because of that and because we're using rate of return, that's why we see the phenomena and the potential risk exposure on wireless expansion. And the issue is is there a way to maintain no model, rate of return, and create a rough-justice balance. That was the question I was highlighting.

COMMISSIONER NELSON: I have a question for Dr. Selwyn.

Dr. Selwyn, in Mr. Reynold's testimony he refers to the dubious track record of TELRIC. Do you perceive it would be more difficult to apply a TELRIC to rural carriers having the experience of non-rural carriers, or have we learned from that experience that would benefit to applying it to rural carriers?

DR. SELWYN: The dubious experience with TELRIC is in the eye of the beholder. I don't see specifically offhand why would we necessarily not be able to construct models that would establish some indication of order of magnitude for different costs for rural carriers given the parameters of their circumstances. This is not -- quite frankly, it's not rocket science.

These companies, while they each